6. OTHER OPTIONS

The proposed rule and supplementary proposed rule do not present realistic options for crude oil valuation for royalty purposes. There are other options that need to be explored, including a royalty-in-kind (RIK) program and improvements and modifications to the 1988 benchmark system.[32]

ROYALTY-IN-KIND

A properly structured RIK program is one option that would satisfy MMS' concerns regarding simplicity and certainty in the royalty valuation process and would minimize the burden faced by lessees and the administrative costs faced by MMS. The Department of Energy in Alberta, Canada implemented an RIK program in 1996, and the program appears to be successful. In the U.S., there is an industry consensus that an RIK program must be seriously investigated.

An RIK program would greatly simplify the valuation procedure for crude oil. A producer would only be responsible for reporting total production from the lease and the share of that production delivered to a marketer. Lessees would be relieved of royalty reporting responsibilities at the lease. The marketer would then report to and pay MMS based on the crude oil taken and the price paid at the lease. The focus of any audits becomes production volumes rather than the price received for crude oil.

Such a program would result in administrative savings to both MMS and lessees. The cost to MMS of performing audits would be dramatically reduced as they would be focused on production volumes, not on whether or not royalty was based on an arm's-length price. Similarly, for lessees, an RIK program would result in reduced audit efforts, reductions in conflicts and litigation, simplification of pricing, certainty in pricing, and reduced reporting requirements.

Cooperation between the industry and MMS would be required to design a properly structured RIK program that is revenue neutral and easy to administer. The paperwork and administrative burden of the proposed rule are of such significance that it would be inappropriate to proceed without fully exploring the RIK option.

IMPROVEMENTS TO AND MODIFICATIONS OF THE 1988 BENCHMARKS

Another option for valuation for royalty purposes is to improve and modify the 1988 regulations. The 1988 benchmarks could be modified to eliminate the reliance on posted prices and to make other appropriate adjustments to remove any value added after crude oil is removed from the lease. It is very likely that this could be done in such a way as the make the 1988 regulations less burdensome.

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[32] 53 FR 1218-1222, January 15, 1988.

7. OTHER REQUIREMENTS MMS HAS NOT ADEQUATELY ADDRESSED UNDER THE PAPERWORK REDUCTION ACT

In addition to not addressing the many comments raised by industry and OMB, MMS has also inadequately addressed some other requirements of the PRA. This section discusses six of those issues.

A. *An information collection with such broad implications ought to be pilot tested before being implemented on a wide spread basis.*

Under the PRA, MMS has a responsibility to test any proposed collection of information through a pilot test, if appropriate.[33] MMS has not pilot tested proposed Form MMS-4415. Given the apparent uncertainty of both MMS and industry concerning how the information to be collected on Form MMS-4415 is to be used, both the form and the analysis should be pilot tested before being used on a wide spread basis.

B. *Proposed Form MMS-4415 will be particularly burdensome on small businesses.*

The PRA requires that MMS reduce the burden on small business.[34] The original proposed rule contained no relief for small business. While the supplementary proposed rule makes some minor concessions to small business by allowing companies who purchase small amounts of crude oil to use a gross proceeds methodology and allowing the gross proceeds method to be used on some crude oil subject to a call, the rule provides no reporting relief for small companies.

C. *Confidentiality under the proposed rule makes it effectively impossible to challenge published differentials.*

Information provided to MMS on Form MMS-4415 would be exempt from disclosure under Federal law. This confidentiality makes it effectively impossible for a lessee to challenge any location/quality differential published by MMS. Given the uncertainty over how to complete the form and over how the data will be analyzed and used, inequitable and erroneous result are virtually certain to occur.

D. *MMS has not yet demonstrated how the information it collects on Form MMS-4415 will be used other than in a very general way.*

MMS has not yet demonstrated how the information it collects on Form MMS-4415 will be used other than in a very general way. As previously discussed, there are numerous potential problems with the proposed information collection, including questionable statistical validity and the representativeness of the information.

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[33] 5 CFR 1320.8(a)(6)
[34] 5 CFR 1230.9(c)

E. The proposed rule retroactively changes contract terms.

Proposed Form MMS-4415 differs from many forms that must be evaluated under the PRA in that it affects a contractual relationship between the Federal government and a lessee, where the lessee agrees to pay the government a royalty for the oil it produces on government-owned land. At the time the lessee enters into a lease with the Federal government, the lessee pays a lease bonus. When the lessee entered into that contract, the company believed it was fully aware of the terms of the contract and the administrative and record-keeping burden necessary to comply with its terms. The proposed rule effectively changes contract terms for all existing contracts on a retroactive basis and takes a share of the value for which the lessee initially bid. Had the proposed rule been in effect when the contracts were initially approved, the lessees might have negotiated different terms or decided not to enter into the lease agreement.

The proposed rule imposes a deadweight loss on society as a whole. It effectively bases royalty payments on a value higher than the value of crude oil at the lease because it includes a duty to market the oil after it leaves the lease. This is economically equivalent to a tax. The higher royalty that is now required could make some leases uneconomic, resulting in premature abandonment of the lease or cause a decline in new investment that could otherwise be used to further develop the property. That decline in production represents a deadweight loss to society. Furthermore, by effectively reducing the value to a potential lessee of any Federal oil lease, the additional burden on lessees is expected to reduce the Government's proceeds from future lease bonuses.

F. Use of proposed Form MMS-4415 data will create risk and uncertainty in crude oil valuations and result in economic inefficiencies that MMS failed to recognize or analyze in its Paperwork Reduction Act burden estimates.

Implementation of MMS' proposed location/quality differential will lead to otherwise identical crude oil being valued differently depending upon the nature of the contractual relationship between the buyer and the seller. While differences in actual arm's length prices are normal and to be expected as a result of local supply and demand fluctuations and the specific requirements of the buyer and the seller, this should not occur under a formulary approach imposed by regulation. In the first instance, price variation is market driven, while in the second the difference is capricious and arbitrary.

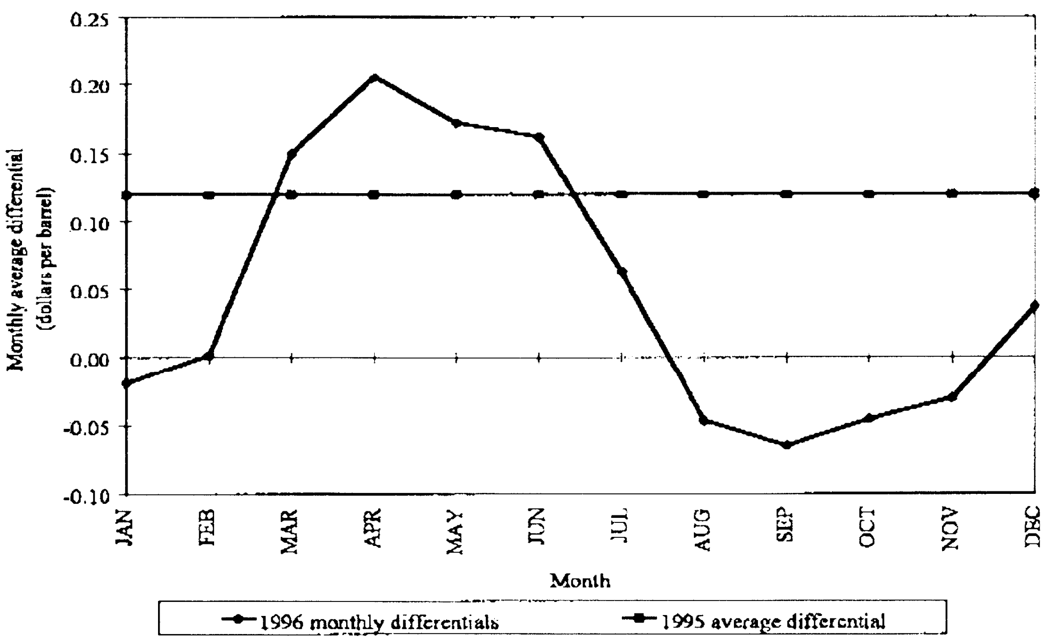
These inconsistent results arise under the proposed rule where one lessee that is not allowed to value its crude oil using gross proceeds engages in an arm's length buy/sell or exchange agreement with a differential specified in the contract. Under the proposed rule, the differential specified in the contract must be used to value this transaction. The transaction must be reported on proposed Form MMS-4415 where it will affect MMS' published location/quality differentials to be used in valuing crude oil the next year. Another lessee selling identical crude oil at the same time is required to value its transaction for royalty purposes using an MMS' published location/quality differential from Form MMS-4415 filings for transactions occurring during the prior year. Thus, lessees selling otherwise comparable oil but engaging in different types of transactions will be forced to value their crude oil differently: one transaction would be valued using an actual contemporaneous differential, the other a dated and averaged differential.

The distortion in values can be illustrated by an example using WTI spot prices at Cushing and Midland. While these are market centers and the proposed rule would not require the publication of an oil price differential for these locations, the availability of actual data makes this comparison useful.[35] Now, consider two transactions that must be valued under the proposed rule. One is an exchange with a differential that has been established using reported spot prices for that day in Cushing and Midland. The other transaction occurs at Midland where the MMS published differential is used. The horizontal line in Figure 2 shows the 1995 average spot price differential between Cushing and Midland for WTI, which was +$0.12 per barrel. That is, the average price of WTI in Cushing during 1995 was $0.12 higher than the average price for WTI in Midland.[36] Also shown in Figure 2 are the 1996 average monthly spot price differentials.[37] Assume the 1995 average is a proxy for MMS' published differential that would have been used during 1996 had the proposed rule been in effect, and assume the average monthly differentials represent actual differentials for the exchange transaction. The required use of the published differentials results in misvaluation of the transaction that would be based upon Form MMS-4415 data from 1995. The extent of the misvaluation is represented by the difference between the two lines shown in the figure.

[35] Under the proposed rule, the difference between spot prices in Cushing and Midland is used to adjust the NYMEX price at Cushing to create a theoretical NYMEX price at Midland. An oil price differential would then be necessary to adjust the value of crude oil that is first traded at an aggregation point away from Midland.
[36] During 1995, the monthly spot differential ranged from +$0.28 in February to -$0.12 in July.
[37] The annual average differential over all of 1996 was +$0.05, or $0.07 below the average differential in 1995.

Figure 2

Average Spot Price Differentials for WTI at Cushing and Midland
(WTI at Cushing less WTI at Midland)



In January 1996, the Midland transaction would be valued by subtracting $0.12 per barrel from the monthly average NYMEX price, while exchange transaction between Midland and Cushing would be valued by adding $0.02 to the NYMEX price. That is, the January spot price of WTI in Midland was actually $0.02 higher than the price of WTI in Cushing. The difference in valuation for the two transactions would therefore be $0.14 per barrel. In April 1996, the Midland-based transaction would again require the subtraction of $0.12 per barrel from the monthly average NYMEX price, while the exchange transaction would require the subtraction of $0.21 per barrel from the NYMEX price. In this case, the difference in valuation would be $0.09 per barrel. September shows the greatest discrepancy with WTI selling for $0.06 more per barrel in Midland than WTI in Cushing. As a result, the disparity between the two methods results in a misvaluation of $0.18 per barrel. Thus, the proposed rule not only improperly values the crude oil overall, but it misvalues it to different degrees for different transactions at different points in time.

Actual misvaluations are likely to greatly exceed those presented in this example. Because the example is based on spot prices for WTI, which is extensively traded, the daily, monthly, and annual variations in price between Midland and Cushing are relatively modest. Few, if any MMS-defined market center-aggregation point pairs will likely be as statistically robust as indicated by this example, which in turn will result in much greater discrepancies.

The conclusion we draw is that price distortions such as those illustrated in this example will reduce economic efficiency and distort investment choices. The arbitrary and capricious nature of these distortions will create uncertainty and risk for those lessees required to use MMS' published location/quality differentials. One consequence, is that lessees will require higher returns on their investment to compensate for the added risk. As a result, some projects with marginal economics will not be completed; e.g., wells will not be drilled, pipelines will not be built or extended, properties will be shut-in or abandoned earlier than otherwise, and lease bonus bids will be reduced. The proposed rule, therefore is not only administratively burdensome, but also reduces economic efficiency. MMS failed to consider or analyze this burden in either the proposed rule or the supplementary rule.

8. CONCLUSIONS

Our analysis of the supplementary proposed rule leads us to conclude that MMS has not significantly reduced the paperwork burden. While MMS addressed a few relatively minor issues, they failed to address substantive issues raised by industry or OMB. Issues MMS has not adequately addressed include: the administrative and record-keeping burdens imposed on companies; the systems costs required to comply with the proposed rule; the unfair treatment of transportation costs; the compliance difficulties resulting from inadequately addressing the definition of "like quality" oil; the deadweight economic loss resulting from retroactively changing contract terms; the increased risks and costs of proposing an interim rule; the potential for misunderstanding the instructions to Form MMS-4415; the lack of a meaningful response to OMB's request to reduce the universe of respondents; and the inadequate detail on how the information will be used to calculate location differentials.

In addition, the supplementary proposed rule creates new problems. By restricting the data collected, MMS will reduce the statistical validity of data it does collect. The supplementary rule increases the distributional inequity among lessees.

Finally, the paperwork and administrative burden of the proposed rule and supplementary proposed rule are of such significance that it would be inappropriate to proceed without fully exploring other options for valuing crude oil. These options include an expanded royalty-in-kind program and improvements to and modifications of the 1988 benchmarks.

APPENDIX

PROPOSED INSTRUCTIONS AND FORM MMS-4415

3758 Federal Register / Vol. 62, No. 16 / Friday, January 24, 1997 / Proposed Rules

Instructions for Completing Form MMS–4415 Oil Location Differential Report

This form's purpose is to collect value differential data for exchanged oil, whether the exchange takes place at the lease or downstream of the lease. These differentials may be related to quality, volume, or location. MMS will use this information to value Federal oil—see 30 CFR 206.105(d)(3). For each contract where oil is exchanged between non-affiliated parties, fill out the requested information on a separate Form MMS–4415. Attach additional sheets if necessary. Do not include production subject to call rights where another party has the right to purchase oil at some redefined price basis or to match other purchase offers.

Company (Payor) Information

Fill out your company name (whether lessee or affiliate), address, and zip code. If additional forms are needed to provide the required information, the address may be omitted from subsequent forms provided that the cover form containing the address is attached.

Write in your MMS payor code on each form submitted.

Write in the reporting period this form covers.

1. Contract Party Name: Write the name of the party you contracted with to transfer your oil. If that party has an MMS payor code, write it in the space provided (if known).

2. Contract Type: Check the appropriate box to indicate the contract type. [Buy/Sell is an exchange where monetary value is assigned to settle both transactions in the exchange. Non-Cash Exchange is a transaction where no monetary value is assigned to either transaction in the exchange; instead, a dollar amount is assigned to the difference between the two values. Sales Subject to Balancing are transactions tied to an overall exchange agreement (either expressed or implied) where volumes purchased and sold by each party are in balance.] Also, fill in the Contract Number that would allow a third party to clearly identify the document.

3. Contract Term: Fill in the date the contract started and its initial term in months. Check the expiration term that applies.

4. Title Transfer Location: Check the appropriate box to indicate where you transferred title to your oil and where you took title to oil you received under the exchange. If title transferred at an MMS lease, write in the 10-digit MMS lease number. If the contract applies to production from multiple Federal leases, attach a separate sheet identifying them. Otherwise, check the appropriate box and enter the location that title transferred.

Fill in the cost ($/barrel) of transporting oil you produced from the production location to the point where title transfers. If the contract so specifies (or this information is known to you) fill in this information for oil you receive or sell. Describe the terms (i.e. starting location, ending location) involved in the transportation of the oil. Use MMS aggregation points (if available) or State, Section/Township/Range if not an MMS aggregation point. Where oil traverses more than one aggregation point be sure to include all segments of the transportation route. Do not include the cost of gathering. Attach a separate sheet, if needed, to adequately describe the transportation.

5. Volume Terms: Fill in the volume in barrels per day of oil sold or transferred. If the contract states that all available oil will be purchased, write in the estimated barrels per day of oil (sold/received). Otherwise, write in the fixed volume (sold/received) specified in the contract.

6. Crude Quality: Fill in the API Gravity of the oil you sold and the oil you received to the nearest tenth of a degree. Fill in the Sulfur Content of the oil you sold or transferred to the nearest tenth of a percent.

7. Pricing Terms:

Posted Price Basis: If the contract references a posted price, write in the name(s) of the company or companies posting(s) and the crude oil referenced in the posting(s). List any premium (+) or deduction (-) to the referenced price(s).

Formula Price: If the contract uses a formula to determine price, completely describe the method used.

Fixed Price: If the price is set through the duration of the contract, list the price per barrel.

Other: Fully describe the method used if it is not covered under any of the above pricing provisions.

8. Quality Adjustments:

API Gravity: Check the appropriate box. If the gravity is deemed, write the deemed API gravity to the nearest tenth of a degree and any corresponding price adjustment from the contract. If an actual reference gravity is used to make an adjustment, write the gravity to the nearest tenth of a degree and the corresponding price adjustment from the contract.

Sulfur or Other Adjustment: Write any other adjustment(s) specified in the contract and the $/barrel adjustment(s).

The Paperwork Reduction Act of 1995 requires us to inform you of the following: (a) this information is being collected to aid the Minerals Management Service in its efforts at determining a fair value of oil for royalty calculation purposes from which location differentials can be calculated and published for lessees' use in reporting royalties; (b) the burden to complete this report is estimated at one-quarter hour; (c) comments on the accuracy of this burden estimate or suggestions on reducing this burden should be directed to the ICCO, MS 2053, MMS, 381 Elden Street, Herndon, VA 20170-4817; (d) this collection of information is mandatory and responses are considered proprietary (5 U.S.C. 552); and (e) an agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number.

Appendix A to Preamble of Oil Valuation Rule

OMB [illegible]
Expires

Oil Location Differential Report

Payor Name: ______________ Payor Code: ______
Address: ______________ Reporting Period: ______ 19 ___ to ______ 19 ___
City, State ______________ Zip ______

1. Contract Party Name	______________ MMS Payor Code (if available) ______	
2. Contract Type and I.D.	☐ Buy/Sell ☐ Non-Cash Exchange ☐ Sale subject to balancing. Contract Number ______	
3. Contract Term	Effective Date: ___/___/___ (MM/DD/YY) Initial Term: ______ (Months) Expiration Terms ☐ month-to-month extensions; ☐ fixed duration	
	Oil You Sold or Transferred	**Oil You Received**
4. Title Transfer Location	☐ MMS Lease Number ______ ☐ Market Center ______ ☐ Aggregation Point ______ ☐ Other ______ Cost of transporting from lease to the transfer point ______ $/BBL Describe cost ______	☐ MMS Lease Number ______ ☐ Market Center ______ ☐ Aggregation Point ______ ☐ Other ______ Cost of transporting from lease to title transfer point ______ $/BBL Describe cost ______
5. Volume Terms	☐ All Available (______ Est. B/D) ☐ Fixed (______ Fixed B/D)	☐ All Available (______ Est. B/D) ☐ Fixed (______ Fixed B/D)
6. Crude Quality	API Gravity: ______ API Sulfur Content ______ %	API Gravity: ______ API Sulfur Content ______ %
7. Pricing Terms	☐ **Posted Price** Posting Company Name(s) ______ Posted Crude Type/Designation ______ Premium/Deduct to Posting ______ $/BBL ☐ **Formula Price (Describe)** ______ ☐ **Fixed Price** ______ $/BBL ☐ **Other (Describe)** ______	☐ **Posted Price** Posting Company Name(s) ______ Posted Crude Type/Designation ______ Premium/Deduct to Posting ______ $/BBL ☐ **Formula Price (Describe)** ______ ☐ **Fixed Price** ______ $/BBL ☐ **Other (Describe)** ______
8. Quality Adjustments	API Gravity Adjustments: ☐ No Deductions ☐ Deemed ___ °API, ___ $/BBL ☐ Actual ___ °API, ___ $/BBL Sulfur or other Quality Adjustments: Description: ______ Adjustments: ______ $/BBL	API Gravity Adjustments: ☐ No Deductions ☐ Deemed ___ °API, ___ $/BBL ☐ Actual ___ °API, ___ $/BBL Sulfur or other Quality Adjustments: Description: ______ Adjustments: ______ $/BBL

Have you received any other consideration, in any form, for the sale or purchase of this crude oil, either at this location or at any other location? (☐ Yes, ☐ No). If Yes, Explain: ______

Authorized Signature ______ and Date ______

Form MMS-4[illegible] (1/97)